



FACING FACTS QUARTERLY

A Report about Entitlements & the Budget from The Concord Coalition

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The President's New Fiscal Strategy— Still Out of Balance

Re-elected presidents rarely propose a turnaround in fiscal policy. But President Bush says he's trying. While during his first term Bush opened the floodgates on federal spending and set deficit records, during his second term he is announcing a new theme of "spending restraint" and says he will take "the steps necessary to achieve our deficit reduction goals." Unfortunately, this hype is not backed by much substance. Yes, the new Bush promises more than what the old Bush delivered. But that's a low hurdle to clear. The new Bush's fiscal policy remains seriously out of balance.

On the positive side, the 2006 Budget shows that this administration is willing at last to stand up to powerful spending constituencies, from the farm lobby to the vet lobby. The White House is daring to earmark 99 programs for elimination and another 55 for major reductions. It is talking tough to state governors about Medicaid spending. And it should be commended for trying to focus public attention on Social Security's long-term cost growth, an issue most Democratic leaders have ritually ignored.

That said, the administration's overall fiscal strategy shows a striking absence of balance, candor, and long-term realism. Take balance. More than two-thirds (\$138 billion) of all the five-year cuts are supposed to come from the 18 percent of outlays that are "non-security" domestic discretionary spending, everything from training and transportation to NASA and national parks. By 2010, this part of the budget is slated to shrink by 16 percent in real dollars.

Much less (\$39 billion) is being asked of the 55 percent of outlays that are "mandatory" entitlements. Indeed, the same President who has yet to veto a single spending bill has declared he would never agree to pare back the massive prescription drug add-on to Medicare he pushed through Congress last year (at a 10-year cost of \$724 billion). And nothing at all, of course, is being asked on the revenue side, where the administration insists on extending its whole range of tax cuts (at a 10-year cost of \$1.1 trillion). Although it wants to reinstitute the congressional pay-go rule, it would rewrite it to exempt tax cuts from the same procedural safeguards that would apply to spending hikes.

So lopsided is this corner-squeezing exercise in fiscal

restraint that it does not do much to reduce the deficit. Even with a growing economy to fill its sail, the plan can "cut the deficit in half" only under an arbitrary set of assumptions (requiring us, for example, to ignore the certain cost of the war on terror and the near-certain cost of providing Alternative Minimum Tax relief). Realistically, the plan will never pull the deficit under \$300 billion by 2010.

Further out, in a future deliberately veiled by the administration's short 5-year horizon, the deficit will balloon

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as the Boomer retirement starts pushing the growth of Medicare, Social Security, and other health and pension payments into high gear. By 2025, the White House's own long-range model projects that the government will be borrowing from the rest of the world to afford a budget that spends 85 percent of its outlays on retirement, defense, and interest. The White House lacks candor not just for its near-term smoke and mirrors, but for obfuscating what the 2006 Budget itself confesses—that "our greatest fiscal challenges are the long-term unfunded liabilities of our entitlement programs." This is a vast challenge. It cannot be met by zeroing out energy labs or teacher workshops.

To be sure, the President has issued a bold proposal for reforming Social Security. But as yet his proposal includes no measure that addresses what he himself agrees is the real problem, namely, the growing future gap between program receipts and expenditures. Instead, he has focused on ways to divert payroll taxes into personal accounts, an idea which might be part of an effective reform plan that also included some new contributions or a pay-as-you-go benefit cut. Alone, however, personal accounts will probably make the problem worse. (See the following essay.)

The White House may have hoped that the public would be strongly attracted to the implied prospect of a free lunch. If so, it miscalculated. Many Americans have reacted with puzzlement, others with the suspicion that the White House is trying to play bait-and-switch, inventing a fictional "crisis" in order to get personal accounts.

The President's defenders say critics just don't appreciate his reform's cultural message—how his personal accounts will create "a society of owners." But what about creating a society of savers? Let's be honest. We Americans have no problem owning stuff. The real problem is—from our houses to our cars and now to our retirement funds—we are in hock for everything we own. Paying off our debts: Now that would be a cultural message worth listening to. ■

We hope you like the new look of FACING
FACTS, which is now a quarterly publication.

The Real Problem with the President's Social Security Plan

Face to face with the greatest fiscal challenge of the new century—coping with the projected cost explosion in Social Security and other senior entitlements—both political parties are practicing a game of denial and diversion.

Many Democrats argue that Social Security requires only minor adjustments. They are wrong. According to the official report of the Social Security Trustees, America's age wave is about to push the program into an inexorable slide toward bankruptcy by the time today's thirty year-olds retire. Long before then, Social Security will become a mounting burden on the budget and the economy.

To their credit, the President and a few GOP leaders in Congress have taken the lead in pointing out the urgent need for Social Security reform. Unfortunately, the President's only concrete proposal—a debt-financed personal accounts “carve out”—would do nothing to solve the problem he outlined in his State of the Union Address. Indeed, it might even make the problem worse.

That problem is closing the long-term gap between what Social Security is promising in benefits and what it can afford to pay. Addressing it will require that retirees take less out of the system or that workers put more in. As now formulated, the President's plan would do neither.

Wading out to the Sandbar

The President would give workers the option of carving out 4 percentage points of the current Social Security payroll tax and diverting it to a new system of personal accounts that would be invested in private financial markets. In exchange, workers would forgo a portion of their traditional Social Security benefit equal, in present value terms, to their carved-out FICA taxes. This benefit offset only serves to keep the carve out from digging a deeper hole. It does nothing to fill the hole we are already in—that is, it does not reduce by one dime the future debt Treasury would have to issue in order to honor Social Security's benefit promises.

There are other serious problems with this proposal as well—starting with the massive borrowing it requires. For every dollar that workers put into their accounts, Congress will have to borrow a dollar to replace the lost FICA revenue, at least until the benefit offset begins to kick in. According to the administration, the plan would add \$754 billion to the federal debt over the next decade. This figure, however, is deceptively low, since the personal accounts won't go into effect until 2009. Over the first ten years the plan is actually in operation, net new borrowing would come to roughly \$1.5 trillion, assuming two-thirds of eligible workers participate. Over the first twenty, it would come to roughly \$5.0 trillion.

The administration tries to downplay the significance of the borrowing by maintaining that it doesn't really constitute an extra cost at all. According to this argument, the President's plan would not be creating new debt. It would merely be translating a portion of the federal government's implicit debt to future Social Security beneficiaries into ex-

PLICIT DEBT TO THE PUBLIC.

The administration is correct—and that's precisely the problem. To the extent that the President's plan translates implicit Social Security debt (which has no constitutional protection) into formal Treasury debt (which does), it in effect renders future Social Security benefits unreformable. The economy might collapse or the nation go to war, but short of default on the national debt Congress would have no way to reduce Social Security obligations.

Keep in mind that the cost of servicing the new Treasury debt would be immediate and certain, while the offsetting savings in implicit Social Security debt would be anything but. It will be a few decades before the benefit offsets become significant—if indeed they occur at all. What if the personal accounts fail to perform as advertised, creating pressure for future Congresses to scale them back? From Medicare to military retirement, the history of entitlement reform is one of back-ended benefit cuts that are rescinded as soon as they begin to bite. Betting on debt-

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leveraged personal accounts is a bit like wading out into the surf to reach a sandbar. You risk drowning before you get there.

Many proponents of the carve-out approach believe that leveraging the transition to a personal accounts system is worth the risk because the long-term rate of return on stock-heavy accounts is sure to be higher than the long-term rate of return on the federal debt. There you have it—the free lunch in a nutshell. By financial alchemy, a lot more benefits are supposed to come out of the system without anyone putting anything more into it. Some GOP members of Congress actually believe that higher returns on personal accounts will not only enrich account holders, but will allow the government to pay off Social Security's liabilities.

If this sounds too good to be true, that's because it is. Very few economists believe that you can generate new wealth simply by shuffling assets from one financial instrument to another. Think about it this way: If this kind of large-scale financial arbitrage could work, why should government stop at putting a thousand borrowed dollars per year into each worker's personal account? Why not, in the first year, put a million borrowed dollars into each account? Forget Social Security reform. We've just come up with a way to turn every American into “Joe Millionaire.”

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In fairness, the administration itself does not claim it will be able to cash in on the spread between stocks and bonds. The administration, however, wants it both ways. To the public, it implies that the personal accounts will more than make up for the reductions in traditional benefits—which is another way of saying that stocks will outperform bonds. To the experts, it denies that its plan depends on the spread. But if the administration thinks that workers will lose as much in traditional benefits as they gain in their personal accounts, what's the point? Building an "ownership" society is all well and good, but in and of itself it does nothing to solve the Social Security problem.

The Missing Ingredient

Does this mean that personal accounts are a bad idea? Not at all. It simply means that the President's proposal is missing the essential ingredient—net new savings.

The case for transitioning at least in part from today's pay-as-you-go Social Security system to a funded system is compelling. At the macro level, genuine funding translates into higher productivity, higher wages, and higher national income. At the micro level, it can offer workers larger benefits for any given level of contributions. Why? Because in a funded system, worker contributions generate a return equal to the rate of return on capital, which is typically much greater than the return on contributions in a pay-as-you-go system, especially when the population is aging.

Although funding can in principle be accomplished collectively through public budgets, in practice government funding doesn't work. So long as Congress owns worker contributions, Congress can spend them, which is precisely what it has done with the existing Social Security trust fund. In the end, personal accounts may be the only "lock box" that no politician can pick.

Genuine funding, however, requires genuine resource trade-offs. To save more, we must consume less—at least until we begin to enjoy the productivity benefits of the higher savings. This in turn means that workers must contribute more, beneficiaries must receive less, or some combination of the two. The administration acknowledges that this is indeed the central challenge of Social Security reform—but it decided to punt rather than face the challenge head on.

Many of the criticisms of the President's personal accounts proposal are misplaced. Workers' account balances would not be eaten up by pricey broker fees. The system the President proposes would be highly regulated, with workers required to choose from a small number of low-cost generic stock and bond portfolios. Nor would workers be at risk of a sudden market down turn just before retirement—at least not if they choose the administration's default "life cycle portfolio" that automatically shifts assets from stocks to bonds as workers age.

The problem with the President's plan is more fundamental: Debt-leveraged accounts do not add to national savings—and so will not leave society better off.

The Obvious Alternative

The obvious alternative to a personal accounts carve out is a personal accounts "add-on." Instead of diverting

existing FICA contributions to personal accounts, the add-on approach would fund the accounts partly or wholly from new worker contributions. It offers a way to ensure the adequacy of future benefits without recourse to financial arbitrage or budgetary shell games.

Let us be clear. Raising payroll taxes to extend Social Security's pay-as-you-go chain letter is not a viable option. Young workers would ask why they must pay more than today's midlife Boomers for the same (or worse) benefits. And middle- and low-income workers, who bear most of the burden, would ask why they must pay more to subsidize the high-income old. Some advocate getting the wealthy to contribute more by levying payroll taxes on all earnings, without a limit on income. But eliminating the "max cap" would destroy the whole presumption of a contributory system—that what people get back in benefits be at least somewhat proportional to what they pay in. In any case, it wouldn't come close to generating enough new revenue to close Social Security's gaping long-term cash deficits.

Worker contributions to add-on accounts would have none of these drawbacks. They would constitute personally owned property and be bequeathable to heirs. As such, government could not spend them. And as such, they would not constitute a tax—or at least they would not function like one.

Again, let us be clear. We are not talking about some new-fangled IRA. To work, the personal accounts add-on would have to be part of an overall Social Security reform plan that cuts back unsustainable pay-as-you-go benefit promises. It would also have to be mandatory. Many reform proposals, including the President's, call for voluntary personal accounts. This is a big mistake. Society has an interest in ensuring that people do not under-save during their working lives and become free riders on the means-tested safety net in old age. "Choice" is besides the point in a compulsory floor-of-protection program whose main purpose is to protect people against poor choices.

A Grand Compromise

The kind of add-on approach we have outlined could appeal to both sides in the debate. It would allow Democrats to say that they have preserved Social Security's solvency without "gutting the trust fund." And it would allow Republicans to say that they have introduced personal accounts without raising taxes.

Yet if there is to be a grand compromise, both sides in the debate will have to rethink the positions they have staked out. Democrats will have to stop circling around the trust fund and acknowledge that the current system is fiscally unsustainable and generationally inequitable. Republicans will have to begin to think of personal accounts as a means instead of an end—and recognize that issuing debt to finance the transition to a funded Social Security system undermines the whole purpose of reform.

Political leaders in both parties are hesitant to compromise for fear of losing political advantage. It's time—while there's still time—to rise above partisan politics. It's time to recognize that, unless we enact genuine Social Security reform soon, the real losers will be our children and grandchildren.■

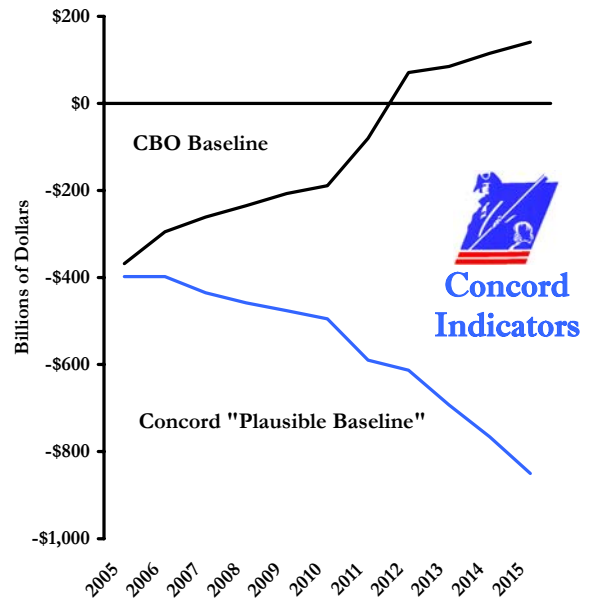
Federal Budget: Debt & Deficits	Bill \$	% GDP	Fed Outlays: FY 2004	Bill \$	% Budg
Gross Federal Debt: End of 2004	\$7,355	63.4%	Social Security	\$492	21.5%
Statutory Debt Limit	\$8,184	NA	Medicare	\$297	13.0%
Publicly Held Debt: End of 2004	\$4,296	37.2%	Medicaid	\$176	7.7%
Debt Held by Foreigners: End of 2004	\$1,886	43.9%*	Other Entitlements	\$381	16.6%
Net Interest Payments: FY 2004	\$160	1.4%	Domestic Discretionary	\$441	19.2%
			Defense	\$454	19.8%
Budget Balance in FY 2004	-\$412	3.6%	Net Interest	\$160	7.0%
Budget Balance in FY 2005: CBO Estimate	-\$368	3.0%	Offsetting Receipts	-\$109	-4.8%
10-yr Budget Balance: CBO Projection	-\$855	NA	TOTAL OUTLAYS	\$2,292	100%
10-yr Budget Balance: Concord Projection†	-\$5,777	NA	(minus) REVENUE	\$1,880	NA%
Budget Balance in FY 2015: CBO Projection	\$141	0.7%	(equals) DEFICIT	\$412	NA%
Budget Balance in FY 2015: Concord Projection†	-\$850	4.3%			

*Percent of publicly held debt. †Concord's "plausible baseline" assumes that discretionary spending grows with GDP, that operations in Iraq and Afghanistan are scaled back to about half of today's level, and that all expiring tax provisions are extended with AMT relief.

GAO's Long-Term Budget Scenario* (% GDP)					
	1962	1980	2000	2020	2040
Discretionary	12.7%	10.1%	6.3%	7.6%	7.6%
Entitlements*	4.9%	9.6%	9.8%	13.8%	20.3%
Net Interest	1.2%	1.9%	2.3%	3.8%	16.6%
Revenue	17.6%	19.0%	20.9%	17.4%	17.4%
Budget Balance	-1.3%	-2.7%	2.4%	-7.8%	-27.1%
Pub Held Debt	43.7%	26.1%	35.1%	81.0%	344.5%

*Assumes that discretionary spending grows with GDP and all expiring tax provisions are extended; entitlements are net of offsetting receipts.

**Federal Budget Balance, FY 2005-2015
CBO vs Concord "Plausible Baseline"**



National Savings (% GDP)	2003	3rd QTR 2004
Personal Savings Rate*	1.4%	0.7%
Net Private Savings	4.6%	4.3%
State & Local Savings	0.0%	0.0%
Federal Savings	-3.3%	-3.2%
Net National Savings	1.2%	1.1%
Current Account Balance	-4.8%	-5.6%
Intl Investment Position	-24.0%	NA

*Percent of disposable income.

Social Security & Medicare	Social Security	Medicare HI	Medicare SMI & Drug Benefit**	Social Security & Medicare
Payroll Cost Rate in 2005	10.9%	3.2%	1.9%†	15.9%†
Payroll Cost Rate in 2040	17.8%	7.2%	8.3%†	33.2%†
75-Year Liability (PV \$)**	\$5.5 TRILLION	\$8.8 TRILLION	\$19.5 TRILLION	\$33.8 TRILLION
Infinite-Horizon Liability (PV \$)**	\$11.9 TRILLION	\$22.0 TRILLION	\$39.8 TRILLION	\$73.6 TRILLION
Date of First Cash Deficit	2018	2004	NA	NA
Date of Trust-Fund Insolvency	2042	2019	NA	NA
Cash Deficit in Year of Insolvency (2004 \$)	\$376 BILLION	\$58 BILLION	NA	NA

†Figures for Medicare SMI & the Medicare drug benefit are net of beneficiary premiums. **Unfunded liabilities are not offset by trust-fund assets.
‡Medicare SMI & the Medicare drug benefit are not financed with payroll taxes; expenditures are shown here as a % of payroll to facilitate comparison.